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SIPDIS

DEPT FOR EUR/RUS, EEB/ESC/IEC GALLOGLY AND GREENSTEIN,

S/EEE MORNINGSTAR

DOE FOR HEGBURG, EKIMOFF

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NSC FOR MMCFAUL

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TAGS: EPET ENRG ECON PREL RS

SUBJECT: FULL GAS PRICE LIBERALIZATION UNLIKELY ANYTIME
SOON IN RUSSIA

Classified By: A/ECON Lynette J. Poulton, Reasons 1.4 (b,d)

SUMMARY

¶11. (C) In 2006, the GOR planned a series of tariff increases to raise domestic natural gas prices for industrial consumers to "market levels" -- that is, European prices minus taxes and transport -- by 2011. However, full liberalization by 2011 appears to be off the table, with the Ministry of Economic Development suggesting a new target of 2012, and independent experts expecting delays until 2017. The GOR's decision to delay gas price reform will likely hinder plans to foster a more efficient economy and prevent more rational gas consumption. End Summary.

GOR PLANS GAS PRICE LIBERALIZATION

¶12. (SBU) In 2006, the Ministries of Industry and Energy, Economic Development and Trade, and Finance, as well as the Federal Antimonopoly and Tariff Services approved a program to increase domestic natural gas prices for industrial consumers to market levels, i.e. netback parity (market price minus taxes and transport) with European prices, by 2011. Regarding non-industrial customers, gas prices for household consumption will reach netback parity by 2015-17 according to the 2008 version of the Ministry of Economic Development's (MED) 2020 Concept for its Socioeconomic Program. (Note: The GOR has heavily subsidized gas prices for both household and industrial consumers since the Soviet era. Industrial consumption represents the vast majority of Gazprom's domestic sales, with household consumption comprising only 28 percent of sales in 2008. End Note.) The GOR decision on raising gas tariffs had been seen as a way to improve economic efficiency and promote more economically rational energy use in Russia, where energy consumption per unit of GDP is among the highest in the world.

¶13. (SBU) The 2006 industrial program envisaged tariff hikes of 15 percent in January 2007, 17 percent in January 2008, four increases of 13 percent each in January and July of 2009 and 2010, and the remainder to reach netback parity in January 2011. However, with European prices variably three to six times higher than domestic prices, many analysts have always been skeptical of the program's feasibility given the obvious political costs.

MARKET PRICING DELAYED TO 2017

¶4. (SBU) In July 2009, MED made it clear that the 2011 target date would not be reached when it announced its intention to raise the domestic natural gas tariff for industrial consumers by 15 percent on January 1, 2010 and to limit annual tariff growth in 2011 and 2012 to 15 percent, well below what would be required to reach netback parity. In October 2009, MED released plans to increase household gas prices by five percent in January and 15 percent in April from 2010-2011 and by 15 percent in 2012. (Note: Household tariff increases are larger than those for industrial consumers because household gas prices are currently significantly lower. End Note.) Deutsche Bank experts contend that achieving European netback parity levels for industrial consumers would require not a 15 percent increase but a 115 percent increase in 2011.

¶5. (SBU) In October 2009, the Ministry of Energy (MOE) proposed to delay a final decision on natural gas price liberalization until July 2010, claiming it would not be ready to equalize European and domestic, industrial prices completely until at least 2012. MOE officials cited concerns over the potential for Gazprom to abuse its dominant market position to benefit at the expense of consumers. Although Gazprom's Board of Directors instructed company management to continue working with the federal government on the transition to market principles for gas pricing by 2011,

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Valery Golubev, Gazprom Deputy CEO in charge of the Russian market, told the press in October that his company did not expect to receive netback parity prices from domestic customers for at least five years. Elena Karpel, Head of Gazprom's Economic Expertise and Pricing Department, subsequently elaborated on this statement, proposing the use of European netback prices from 2011, but with discounts that would gradually disappear by 2014. Deutsche Bank experts assert that even 2014 is not an attainable target and do not expect full-scale liberalization of domestic industrial gas tariffs until 2017, with full liberalization of household prices following sometime later.

DELAY WILL ALSO HIT PROJECTED GAZPROM GAINS

¶6. (SBU) Gazprom has long contended that rising prices in the domestic market -- to which it sells 51 percent of its gas by volume but from which it receives only 21 percent of its revenues -- would help propel its future earnings. The GOR's decision to reduce gas tariff increases in 2010 and delay complete liberalization will thus lower Gazprom's projected gains, at a time when it is already reeling from declining demand and low prices in its major export markets. (Note: Even in an environment of rising domestic gas prices, the effect on Gazprom's bottom line is debatable. Some analysts, citing examples from other countries, predict a strong contraction in demand in response to price hikes. A recent report by Credit Suisse cited the case of Ukraine, where, according to their analysis, demand fell 50% in response to rising prices throughout the 1990s. End note.)

COMMENT

¶7. (C) Although politically convenient given the current economic situation, the GOR's decision to delay gas price liberalization will contribute to continued inefficiencies across the economy. As long as Russian enterprises do not bear the full cost of their use of outdated processes and equipment, they will remain unlikely to invest in the modern

technology and production methods necessary for future
economic growth. End Comment.
Beyrle